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CLIENT ALERT

Tax Cuts and Jobs Act Changes Affecting Real Estate

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On December 22, 2017, an act popularly known as the Tax Cuts and Jobs Act (the "TCJA"), was signed into law. It represents the most significant revision of the U.S. tax code in 30 years. This alert focuses on those changes that may have the most significant effect on the U.S. taxation of cross-border real estate investments.

- ***U.S. Corporate Tax***
    - The U.S. corporate tax rate has been reduced to 21% and the corporate Alternative Minimum Tax has been repealed. Net operating losses can no longer be carried back but may be carried forward indefinitely and now only deducted against 80% of net income.
    - The reduced U.S. corporate tax results in U.S. individual shareholders investing through a corporation being subject to an effective combined tax rate of 39.8% (including Medicare tax) on qualified dividends, down from 50.47%.
    - The TCJA does not change the 30% U.S. federal withholding tax rate (or such lower rate as may be applicable under a tax treaty) on dividends paid by a U.S. corporation to a foreign person. The effective combined U.S. tax rate on foreign shareholders subject to the 30% withholding tax will be 44.7%.
    - The reduction in the U.S. corporate rate may make use of a "U.S. blocker" relatively more attractive than previously, particularly where a treaty is available to eliminate or reduce dividend withholding tax, although new restrictions on interest deductions (see below) may constrain efforts to reduce blocker taxes through leverage.

- ***Pass-Through and REIT Taxation***
  - A taxpayer (other than a corporation) investing through a pass-through entity is now eligible for a 20% deduction of the taxpayer's "qualified business income" (generally certain business income effectively connected with a U.S. trade or business), as well as a 20% deduction for REIT dividends (other than capital gain dividends), resulting in an effective maximum marginal tax rate of 29.6% (plus Medicare tax, when applicable).
  - Income eligible for the 20% deduction does not include professional service business income above a certain threshold and, except for REIT dividends, is limited to the greater amount of either 50% of W-2 wages allocable to the partner or 25% of W-2 wages allocable to the partner plus 2.5% of the depreciable basis in tangible property.
  - While dividends from REITs qualify for the 20% deduction, business income from real property earned through a partnership with minimal wage expense is subject to the 2.5% depreciable property limitation, thus providing an advantage to investment through a REIT.
- ***Limitation on Interest Deduction***. In general, the TCJA limits the net interest expense deduction to 30% of EBITDA for taxable years beginning after 2017 and before 2022, and 30% of EBIT thereafter. Electing real property businesses are exempt from this limitation on interest deductions. For this purpose, real property business includes real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. The election carries with it certain restrictions, such as the inability to immediately expense 100% of the acquisition cost of certain non-real estate property and the use of the somewhat less favorable alternative depreciation system. Corporate groups engaging in both real estate and non-real estate activities should consider structuring borrowing and general corporate structure to maximize the availability of this exception for real property business borrowing.
- ***Immediate Expensing of Capital Expenditures***. The TCJA generally provides for immediate expensing of property acquisitions other than land or buildings. As discussed above, electing real property businesses are not eligible for immediate expensing. The rate of expensing will progressively decline beginning in 2023.
- ***BEAT***. The base erosion and anti-abuse tax ("BEAT") is a new tax assessed at an introductory rate of 5% in 2018 and 10% thereafter, until it rises again to 12.5% in 2026 and beyond. The BEAT applies to large corporate taxpayers—generally, corporations other than REITs and RICs with average annual gross receipts of at least $500 million for the prior three-year period, after aggregating the gross receipts of controlled groups—and is based on a measure of various forms of deductible payments (e.g., interest) from domestic taxpayers to related

foreign persons, which it terms "base erosion payments." The BEAT functions like a minimum tax and could result in limiting the deductibility of interest paid by a leveraged blocker to its non-U.S. shareholders.

- ***Sale of Partnerships Engaged in a U.S. Trade or Business***. The TCJA overrules a recent Tax Court case, *Grecian Magnesite*,[1] and provides that any gain or loss from the sale of a partnership interest by a foreign partner on or after November 27, 2017, is treated as effectively connected with a U.S. trade or business to the extent that the foreign partner would have had effectively connected gain or loss from the sale of the partnership's underlying assets.[2] For sales after December 31, 2017, the transferee of the partnership interest is required to withhold 10% of the amount realized on the sale from a foreign person, and if the transferee fails to withhold, the partnership is required to withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold. This rule will not affect foreign investors in the U.S. real estate market that are otherwise subject to the FIRPTA withholding regime.

- ***Taxation of Carried Interest***. Investment fund managers that are allocated gain with respect to carried interest will generally be entitled to long-term capital gain rate treatment only if the fund held the relevant investment for more than three years at the time of disposition. If the fund held the investment for a shorter period of time, the gain would be treated as short-term capital gain. This rule doesn't apply to other investors in the fund.

- ***Territorial Taxation***. The TCJA shifts towards a territorial system by allowing U.S. corporations to take a 100% dividends received deduction ("DRD") for foreign source dividends from foreign corporations of which the U.S. corporation owns a 10% or greater interest. However, the TCJA does not provide for a full territorial system and a 10% shareholder of a controlled foreign corporation is still required to include its share of subpart F income. Note also that REITs are not eligible for this DRD. The TCJA imposes a one-time transition tax on pre-2018 undistributed earnings and profits of certain foreign corporations at an effective rate of 15.5% on liquid assets and 8% on certain illiquid assets.

- ***CFC Rules***. The definition of a U.S. shareholder has been expanded to include U.S. persons who own at least 10% of either the voting power or value of stock in a foreign corporation—prior law had only measured U.S. shareholders by voting power. Also, the attribution rules applicable to determine whether a foreign corporation is a controlled foreign corporation ("CFC") have been altered such that the stock owned by a foreign person can be attributed downward to a U.S. person. This means that a foreign parent corporation's shares in a foreign subsidiary could be attributed to a U.S. subsidiary, potentially subjecting the foreign subsidiary to treatment as a CFC. These two changes significantly increase the likelihood of a foreign corporation being treated as a CFC.

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1 *See* Grecian Magnesite Mining v. Commissioner, 149 T.C. No. 3 (July 13, 2017), *appeal docketed*, No. 17-1268 (D.C. Cir. Dec. 12, 2017).

2 Rev. Rul. 91-32, 1991-1 C.B. 107.

- ***FIRPTA***. The TCJA has not altered FIRPTA in any significant respect. The TCJA changed the amount of FIRPTA withholding such that it is aligned with the new tax rates that apply to U.S. corporations.
- ***Like-kind Exchanges***. Like-kind exchanges under section 1031 are preserved with respect to real estate but are no longer allowed for personal property. This change may continue to be relevant to real estate owners and investors to the extent that an exchange of real estate also includes other property.
- ***Changes to U.S. Individual Taxation***. The TCJA makes several changes to the taxation of U.S. individuals that may have an effect on the U.S. real estate market, particularly the residential real estate market. In particular, the TCJA limits the amount of mortgage debt on which an interest deduction is permitted to $750,000 for mortgages incurred in taxable years beginning after December 31, 2017 and before January 1, 2026. In addition, the TCJA limits the amount of state and local income, property and sales taxes that may be deducted by individuals to $10,000 per year, which may have a broader impact on states with relatively high tax burdens.

If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

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